

AMOCO PRODUCTION CO. (ON RECONSIDERATION)

IBLA 95-301R

Decided April 28, 1999

Petition for Reconsideration of a Board decision cited as Amoco Production Co., 143 IBLA 189 (1998), on appeal from decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS 91-0150-OCS).

Petition granted, Board decision modified, decision of Minerals Management Service vacated in part and reversed in part.

1. Oil and Gas Leases: Royalties: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties

The Federal lessee's duty to place produced gas in marketable condition at no cost to the lessor includes the obligation to market the gas. Accordingly, a deduction from the sale price for marketing fees or commissions, whether paid by the buyer or the seller, is properly disallowed in calculating royalties.

2. Oil and Gas Leases: Royalties: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties

A decision requiring a lessee to calculate royalties on the basis of its buyer's resale price to its customers may be reversed as unsupported by the record when the resale is by a regulated public utility to its end user consumers (after aggregating gas with gas purchased from other parties) at a regulated price (including a guaranteed return on investment) and there is no evidence in the record that the difference between lessee's price and the consumer price reflects a marketing fee or commission for marketing the produced gas.

APPEARANCES: Jonathan A. Hunter, Esq., New Orleans, Louisiana, for appellant; Sarah L. Inderbitzin, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

Counsel for the Amoco Production Company (Amoco or APC) has filed a petition for reconsideration of our decision in the above-captioned case, cited as Amoco Production Co., 143 IBLA 189 (1998). Reconsideration is sought with respect to the issue of the valuation of residue gas produced from June 1986 through February 1991 from lease OCS-G 5000, processed through the Matagorda Gas Plant and sold by Amoco to its affiliate, Amoco Gas Company (AGC).

In our decision, we upheld an April 9, 1991, order issued by the Chief, Royalty Compliance Division (RCD), Dallas Area Compliance Office (DACO), Minerals Management Service (MMS), requiring Amoco to compute royalties on the basis of "100 percent of the gas value accruing to AGC." In a royalty review, MMS had determined that, for certain test months, valuation for royalty purposes was based on 90 percent of the resale price received by AGC for Amoco's gas. On appeal to the Board, Amoco asserted that MMS ignored the relevant regulation regarding valuation of gas sold pursuant to a nonarm's-length contract. Under that regulation, the value of residue gas or any gas plant product not sold pursuant to an arm's-length contract amounts to the gross proceeds accruing to the lessee, provided that the gross proceeds are equivalent to the gross proceeds derived from comparable arm's-length contracts of like-quality residue gas or gas plant products from the same plant. Amoco contended that its price received on sale of the gas was comparable to prices received under arm's-length contracts.

In its answer, MMS focused on the obligation of the lessee to place production in marketable condition at no cost to the lessor. Since Amoco's price for sale of the gas to AGC was 90 percent of the resale price received by AGC, MMS argued that it properly concluded that the deduction was for marketing expenses payable by the lessee and, thus, not allowable as a deduction from value.

In our decision, we recognized that the value of residue gas not sold at arm's length "is generally determined by reference to the proceeds accruing to the lessee when those are equivalent to the gross proceeds paid under comparable arm's-length contracts for like quality residue gas or gas plant products from the same plant," citing 30 C.F.R. § 206.153(c)(1). In the context of this appeal, however, we found the issue to be the allowance of a deduction for marketing costs. Thus, we noted that the relevant regulation provides:

The lessee is required to place residue gas and gas plant products in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement. Where the value established under this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of

which ordinarily is the responsibility of the lessee to place the residue gas or gas plant products in marketable condition.

30 [C.F.R.] § 206.153(i) (1994). 2/

2/ This regulatory requirement was also found in the regulations in effect prior to the 1988 regulatory revision. See 30 C.F.R. § 250.42 (1986).

143 IBLA at 192-93. We found that Amoco had failed to show error in the MMS decision requiring recalculation of royalty on gas sold to AGC to include the cost of marketing expenses improperly deducted. Id. at 193.

In support of reconsideration, Amoco asserts that the price of the gas it sold to AGC did not reflect a deduction for the cost of placing the gas in marketable condition. Amoco indicates that:

AGC is a regulated utility that purchased gas not only from Amoco, but also from nonaffiliated third parties. After aggregating volumes of gas pursuant to these purchases, AGC sold the gas to end-users for a price that was regulated by the laws governing AGC's status as a utility.

(Petition for Reconsideration at 2.) Amoco contends that the marketable condition rule does not apply in this context. It is asserted that the gas was in marketable condition at the time it was sold to AGC and that any costs incurred by AGC in marketing the product to end users had nothing to do with placing the gas in marketable condition. Further, Amoco argues that, as a Federal oil and gas lessee, it is not obligated to pay AGC's cost to "aggregate volumes of production from numerous producers, form an affiliated company that qualifies as a regulated utility, and sell such aggregated volumes at 'burner tip' prices commanded by a utility." (Petition at 5.) Additionally, Amoco asserts that the only circumstance in which the lessee must pay royalty on the value received by its affiliate on resale of the gas is when the affiliate falls within the regulatory definition of a marketing affiliate, citing 30 C.F.R. §§ 206.152(b)(1)(i), 206.153(b)(1)(i). Amoco contends that AGC does not meet the definition of a marketing affiliate because it did not buy gas only from Amoco, but also purchased gas from third parties.

No reconsideration has been sought of that part of our decision which vacated and remanded the MMS decision in response to the motion by counsel for MMS advising that additional information filed by Amoco had established that it did not owe additional royalty on scrubber condensate and flash gas. Accordingly, that aspect of our decision is not addressed herein.

The issue raised by this petition for reconsideration is whether MMS properly concluded that the difference between the price for the gas received by Amoco and the price received by AGC represented an improper deduction for the cost of placing the gas in marketable condition or a fee for marketing the gas. After receipt of the petition, we requested MMS to

return the case file in this appeal to the Board. We have now reviewed the administrative record again in light of petitioner's assertions on reconsideration. In view of the information presented in the petition and the information appearing in the case file, we deem it appropriate to grant the petition for reconsideration. See 43 C.F.R. § 4.403.

In a memorandum dated September 27, 1988, the Chief, Royalty Valuation and Standards Division (RVSD), MMS, addressed the issue of whether prices received by Amoco under the Short Term Industrial Market Program (STIMP) contract are acceptable for royalty valuation purposes in response to an inquiry by the RCD, MMS. Answering in the negative, RVSD gave the following explanation for its conclusion:

[U]nder 30 CFR § 206.152(d) [(1987) 1/], the royalty value cannot be reduced by allowances for costs of compression or other costs incidental to marketing. Marketing costs include brokering or marketing fees, commissions, normal separation and dehydration, sweetening, and other costs necessary to place the gas in a marketable condition. In view of the fact that the price AGC pays APC is reduced by a separate transportation component, we conclude that the 12.5 percent factor (100%-87.5%) [2/] is either a brokering fee, a marketing fee, a commission, or some combination of fees that are considered costs "incidental to marketing." In accordance with 30 CFR § 206.152(d), this fee cannot be allowed as a deduction from the value for computing royalties.

(Memorandum of September 27, 1988, at 3 (Attachment 7 to Memorandum of January 24, 1992, to Chief, Division of Appeals, MMS, from Area Manager, DACO, MMS).)

In an October 29, 1990, letter to Amoco (Attachment 5 to Memorandum of January 24, 1992), the Acting Area Manager, DACO, MMS, indicated that review of sales of gas from oil and gas lease OCS-G 5000 disclosed the apparent underpayment of royalties in certain sample months in which Amoco valued the gas sold to AGC under the STIMP contract at 90 percent of the resale price received by AGC. Amoco was requested to advise MMS of its response, noting that it "appears that the 10 percent factor may be fees that are considered 'costs incidental to marketing.'" Id. at 2.

By letter dated December 7, 1990, Amoco responded to MMS:

The indication of incorrect gas prices for sample months 6/86, 10/86, 3/87, and 3/89 is unwarranted. Your belief that

1/ This regulation, in effect prior to the 1988 revision of the royalty regulations, provided that: "No allowance shall be made for boosting residue gas or other expenses incidental to marketing."

2/ This figure was subsequently modified by MMS to 10 percent.

royalty should be based on 100% of Amoco Gas Company's STIMP price is incorrect. Amoco Gas is a utility service company regulated by the State of Texas that sells to end users. Their weighted average STIMP price is an end user/"burner-tip" price. Amoco Gas, as a utility, is guaranteed the right of a rate of return on their investment. Present regulations allow payment of royalties to be based on a fair market wellhead price. Said regulations do not require royalties to be based on an inflated "burner-tip" sales price as referenced herein.

(Attachment 6 to Memorandum of January 24, 1992, at 1.)

The MMS Order of April 9, 1991, rejected Amoco's contention. The regulation at 30 C.F.R. § 206.152 (1987) was again cited for the principle that no allowance shall be made for expenses incidental to marketing. In that Order, MMS held that: "In view of the fact that the price AGC pays Amoco is reduced by a separate transportation component, MMS concludes that the 10 percent factor (100-90) is either a brokering fee, a marketing fee, a commission, or some combination of fees that are considered 'costs incidental to marketing.'" (MMS Order of April 9, 1991, at 2-3.)

Amoco challenged the MMS assertion that the price it received from AGC reflected a deduction for marketing fees or expenses in its statement of reasons (SOR) for appeal to the Director, MMS. Conceding that, when the lessee sells gas under a nonarm's-length contract to a marketing affiliate, value may be determined by the gross proceeds accruing to the marketing affiliate, Amoco pointed out that AGC does not fit the definition of marketing affiliate because it "is a regulated utility service company that purchases gas from numerous unaffiliated sellers, in addition to purchasing gas from Amoco." (SOR before Director, MMS, Attachment 4 to Memorandum of January 24, 1992, at 4-5.) Amoco also contended that, under the relevant regulation, the standard for royalty valuation is the proceeds accruing to the lessee when the proceeds pursuant to the nonarm's-length contract are equivalent to the gross proceeds under comparable arm's-length contracts of like quality residue gas from the same gas processing plant. Id. at 5-6. Amoco also tendered evidence that the value upon which it paid royalty for 3 of the 4 sample months was well within the range of prices received by other lessees and was only 4 percent lower for the production month of June 1986. Id. at 9-10.

On appeal to the Director MMS, the Associate Director for Policy and Management Improvement issued the decision dated January 9, 1995, which was the subject of Amoco's appeal to this Board. The Associate Director found that "the difference between the price used by [Amoco] to calculate royalties and the price actually received by [Amoco's] affiliate constituted a brokering fee, marketing fee, a sales commission, or some combination thereof." (Decision at 4.) The decision held that it is well settled that selling expenses necessary to market production from a Federal lease must be performed at no cost to the lessor, citing regulations 30 C.F.R.

§ 206.152(d) (1987) and 30 C.F.R. § 206.152(i). Further, the Associate Director held that the fact that the lessee pays a third party by accepting a reduction in sale price to pay for marketing the gas does not alter the rule. The decision found Amoco's assertion that AGC is not a marketing affiliate as that term is defined in the regulations was not dispositive. Further, MMS found that Amoco's acknowledgment that the price it received from AGC in one of the months was 4 percent below the lowest price received by other Federal lessees coupled with the unexplained differential between the price received by Amoco and the price received by AGC in subsequent sales to third parties negates the claim regarding the comparability to arm's-length sales. (Decision at 4.)

In our prior decision in this case, we held that the issue raised is whether "a deduction may be allowed for costs incurred to market the production." 143 IBLA at 192. We noted that regardless of the comparability of lessee's sale of gas to its affiliate to arm's-length transactions, if the price reflects deductions that may not be made in determining value for Federal royalty purposes, such deductions may be added to the sale price to set the value of production for royalty computation. 143 IBLA at 193. ^{3/} Noting that the 10-percent deduction was distinct from the deduction of allowable transportation expenses, we found that Amoco failed to show error in the MMS decision "requiring recalculation of royalty on gas sold to AGC to include marketing expenses improperly excluded." *Id.* While the principles cited in the Board's prior decision are consistent with the regulations and past precedents, we find it appropriate to further analyze the application of these principles to the case before us in view of the petition for reconsideration.

[1] The regulations governing royalty valuation of processed gas production for the period prior to March 1, 1988, provided in part that: "No allowance shall be made for boosting residue gas or other expenses incidental to marketing." 30 C.F.R. § 206.152(d) (1987); *see* 30 C.F.R. § 250.42 (1987). After March 1, 1988, the relevant regulatory provision continued to recognize the obligation of the lessee to put the gas in marketable condition:

The lessee is required to place residue gas and gas plant products in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement. Where the value established under this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the residue gas or gas plant products in marketable condition.

^{3/} The fact that AGC is not a "marketing affiliate" as defined by regulation, 30 C.F.R. § 206.153(b)(1)(i), is not dispositive on this issue.

30 C.F.R. § 206.153(i) (1995). Under the regulations, the Board has held that the concept of marketable condition embraces not only the physical conditioning of the gas (e.g., separation of impurities, compression, etc.), but marketing services as well. Anson Co., 145 IBLA 221, 225 (1998). Thus, we have held that the creation and development of markets for production is a key part of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of lessee and lessor; a function which Federal lessees are obligated to perform at no cost to the lessor. Taylor Energy Company, 143 IBLA 80, 81 (1998), citing Arco Oil & Gas Co., 112 IBLA 8, 11 (1989); Walter Oil & Gas Corp., 111 IBLA 260, 265 (1989).

[2] In applying this rule, we have held that MMS properly disallowed a deduction for lessee's cost of hiring a marketing agent to find buyers, negotiate sales contracts, and monitor sales of produced gas. Walter Oil & Gas Corp., *supra*. Thus, the gross proceeds to the lessee of the sale of production was held to include the entire contract price paid by the buyer, including that portion which the lessee had contracted to pay to its agent for negotiating lessee's sale contract. Walter Oil & Gas Corp., 111 IBLA at 264. In the Taylor case, the marketing agent contracted to pay the lessee 97 percent of the price which the agent received upon resale of the gas. The Board held that valuation of the gas for royalty purposes cannot be reduced by the amount of the fee for finding a market for the gas, regardless of whether this function was performed by a third party. 143 IBLA at 81.

In Arco, the lessee contracted with a marketing agent to find buyers and to arrange transportation of gas to buyers in remote locations. We held that the cost of marketing or obtaining sales of produced gas even in a distant or remote market are not an allowable deduction from the sale price when the lessee would have sustained similar marketing costs in an effort to obtain the highest price available even if the gas could have been sold on or near the leasehold. 112 IBLA at 10-11. Similarly, in the Anson case, the lessee contracted to sell gas to an agent at a sale price equivalent to the agent's resale price reduced by a 2 percent marketing charge. Accordingly, we held that this marketing charge could not be deducted from the sale price of the gas when calculating value for purposes of royalty computation.

In reviewing these precedents, we find that they all entail both the use by the lessee of an agent to market produced gas and the disallowance of a deduction from the gas sale price for the cost of the marketing agent.

Such marketing costs were disallowed regardless of whether they were paid by the lessee (Arco, Walter) or by the gas purchaser (Anson, Taylor). We find these cases to be distinguishable from the case before us.

In the case of Amoco, MMS assumed that the difference between the price obtained by Amoco on sale of the gas and the price obtained by AGC on resale constituted a marketing fee or commission. See MMS Memorandum

of September 27, 1988, at 3. Amoco, however, responded to MMS that AGC "is a utility service company regulated by the State of Texas that sells to end users." (Amoco letter of December 7, 1990.) Further, Amoco noted that AGC's sale price is an "end user/'burner-tip' price." Id. Amoco also noted that AGC, "as a utility, is guaranteed the right of a rate of return on their investment." Id. After careful review of the record, we find no evidence that the difference between the price at which Amoco sold the gas and the price at which AGC, a regulated public utility, sold the gas to its customers constitutes a marketing fee. Accordingly, the MMS decision requiring Amoco to recalculate royalties on residue gas on the basis of the price received by AGC when sold to its customers is reversed. 4/

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the petition for reconsideration is granted, the prior Board decision is modified, and the decision of MMS is reversed.

C. Randall Grant, Jr.
Administrative Judge

I concur:

David L. Hughes
Administrative Judge

4/ After reviewing the case file while this petition for reconsideration was pending before the Board, counsel for Amoco noted that certain additional documents referenced in the Sept. 27, 1988, MMS memorandum were not found in the record. Counsel requested that the record be supplemented with the documents and that petitioner be given an opportunity to review and comment on the documents. In light of our holding herein, we find the motion is effectively mooted.